SHERROD BROWN
OHIO

COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
APPROPRIATIONS
BANKING, HOUSING, AND URBAN AFFAIRS
VETERANS' AFFAIRS
SELECT COMMITTEE ON ETHICS

United States Senate
WASHINGTON, DC 20510

June 23, 2011

The Honorable Timothy Geithner
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Geithner,

As the global financial crisis and ensuing recession has demonstrated, the safety and stability of our financial system is critical to all Americans. It should be of paramount importance to the regulators tasked with overseeing our financial system. As Chairman of the Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection, I am concerned about Acting Comptroller John Walsh's comments regarding the reforms necessary to protect the safety and soundness of our financial sector.

As you have noted, one of the keys to preventing another financial crisis is "capital, capital, capital."[1] In a speech in London on Tuesday, Mr. Walsh argued that, by implementing strong capital buffers, "we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms to address problems and abuses stemming from the last crisis."[2] In arguing against setting meaningful requirements for banks to fund themselves through equity, Mr. Walsh quoted a 2007 study that concluded that "there is widespread agreement in the theoretical academic literature that the immediate effects of constraining capital standards are likely to be a reduction in total lending and accompanying increases in market loan rates and substitution away from lending to holding alternative assets."[3]

There is now widespread agreement that proposals to require banks to fund themselves using greater equity would not be prohibitively expensive and will not contract lending, and that strong capital buffers are a good thing. In response to written questions following a February hearing in the Senate Banking Committee, FDIC Chairman Sheila Bair stated, "we do not agree that the new [capital] requirements will reduce the availability of credit or significantly raise borrowing costs." She has also said that the current tight lending conditions are due to risk aversion on the part of banks and customer demand, not capital.[4]

---

[1] Damian Paletta & David Wessel, *Bank Rules Win Muted Praise*, WALL STREET JOURNAL, Sept. 13, 2010.
[2] John Walsh, speech delivered at the Centre for the Study of Financial Innovation (June 21, 2011) at 3.
[3] *Id.*, at 9.
[4] *See* Deborah Solomon, *FDIC's Bair: New Capital Rules Won't Hurt Lending*, WALL STREET JOURNAL, June 10, 2011.

In August 2010, Professor Anat Admati and several of her colleagues published a paper explaining that requiring banks to increase their funding through equity will not contract lending.[5]

Nothing has contracted credit more than the financial crisis. That is why David Scharfstein and Jeremy Stein of Harvard University believe that increased capital will make institutions safer, and actually reduce the risk of a credit crunch.[6]

Federal Reserve Bank of Kansas City President Thomas Hoenig has argued that reducing the scope and size of banks, combined with statutory debt-to-equity requirements, would "restore the integrity of the financial system and enhance equity of access to credit for consumers and businesses."[7]

The Acting Comptroller's reliance on pre-crisis research and assumptions is troubling. Equally troubling is Mr. Walsh's representation that there is "widespread agreement" for an assertion that has been disputed, if not discredited, by current research. But most troubling of all is the fact that he has apparently forgotten that excessive leverage and risk-taking led us to the brink of full financial collapse.

Mr. Walsh also argued against meaningful equity funding requirements at the largest financial institutions, saying that "[s]ome modest addition to minimum capital may be appropriate to reflect systemic concerns at the very largest firms, but we should not lose sight of the fact that the other components of Basel III already have been calibrated with one eye on the systemic lessons of the recent financial crisis[.]"[8]

His beliefs are at odds with Dr. Hoenig, who has said that the Basel III requirements of 7 percent Tier 1 capital alone "will not prevent the next crisis and will not adequately prepare institutions for the next crisis."[9] His views are also contradicted by broad international agreement that the standard must be set much higher:

- Federal Reserve Governor Daniel Tarullo has proposed progressive Tier 1 capital funding buffers of 1.4 percent to 7 percent above Basel III – a range of 8.4 to 14 percent.[10]

- In 2008, Former Chairman of the Board of Governors of the Federal Reserve Alan Greenspan suggested 14 percent equity funding.[11]

---

[5] *See* Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive*, Rock Center for Corporate Governance at Stanford University Working Paper No. 86 (Aug. 2010) at 42-47.
[6] *See* David Scharfstein & Jeremy Stein, *Basel Needs a Firm Hand and Fewer Delays*, FINANCIAL TIMES, Sept. 13, 2010.
[7] Thomas M. Hoenig, *Too Big to Succeed*, N.Y. TIMES, Dec. 1, 2010 at A37.
[8] Walsh, *supra*, at 9-10.
[9] *See* Steve Matthews, *Hoenig Says Basel Capital Standards Too Weak to Avert Future Bank Crises*, BLOOMBERG, Apr. 12, 2011.
[10] *See* Daniel K. Tarullo, "Regulating Systemically Important Financial Firms," speech delivered at the Peter G. Peterson Institute for International Economics (June 3, 2011) at 9-10.
[11] *See* Alan Greenspan, "Banks Need More Capital", THE ECONOMIST, Dec. 18, 2008.

- Professor Allan Meltzer has noted that large banks in the 1920s funded themselves using Tier 1 capital ranging from 15 to 20 percent of their assets.[12]

- A government-sponsored panel in Switzerland has said that massive banks UBS and Credit Suisse should hold a 19 percent capital buffer.[13]

- A working paper by staff at the Bank of England found that the optimal capital ratio is at least 15 percent, but could well be in excess of 20 percent.[14]

- The *Wall Street Journal* has even suggested a 15 percent Tier 1 capital requirement.[15]

Increasing banks' funding through equity will reduce "too big to fail" cost subsidies and decrease the likelihood of future crises. The United States academic community understands the importance of strong capital buffers and the need for banks to fund more of their operations through equity. Our colleagues in the international community understand. It seems that one of the few people who does not understand this principle is the Acting Comptroller of the Currency, responsible for overseeing the largest national banks and subsidiaries of foreign banks and faithfully implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010).

Under the leadership of Mr. Walsh's predecessors, the Office of the Comptroller of the Currency looked the other way time and time again as the banks that it regulates – including the largest banks in the country – made risky loans, securitized them, and leveraged themselves to the hilt. Mr. Walsh's comments make painfully clear that he has no interest in learning from his agency's past mistakes. He should be removed from his position and replaced by a new Comptroller who understands the painful lessons that we have learned in bank crises – both at home and abroad – that an unsafe, unsound, and under-capitalized banking system destroys wealth and drains resources from the rest of the economy.

I appreciate your prompt attention to this important matter.

Sincerely,

Sherrod Brown

Sherrod Brown
United States Senate

---

[12] *See* Testimony of Allan H. Meltzer before the Congressional Oversight Panel, Washington, D.C., Mar. 4, 2011, at 2.

[13] *See* Elena Logutenkova & Klaus Wille, *UBS, Credit Suisse May Need to Boost Capital to 19%*, BLOOMBERG, Oct. 4, 2010.

[14] *See* David Miles, Jing Yang & Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31 (Apr. 2011) at 37.

[15] *See* Review & Outlook, *Tarullo's Capital Idea*, WALL STREET JOURNAL, June 16, 2011.